U.S. Department of Justice

Antitrust Division

Office of the Assistant Attorney General

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Beth Farmer, Esquire
Assistant Attorney General
Antitrust Bureau
120 Broadway, Suite 2601
New York, New York 10271

Kevin O'Connor, Esquire
Assistant Attorney General
123 West Washington Avenue
Madison, Wisconsin 53707-7857

Dear Ms. Farmer and Mr. O'Connor:

On behalf of the Antitrust Division of the United States Department of Justice, I am pleased to submit comments on the August 20th draft of the Horizontal Merger Guidelines of the National Association of Attorneys General ("NAAG").

The publication of the first-ever joint Department of Justice and Federal Trade Commission Guidelines marked a substantial step toward harmonized enforcement at the federal level. As you know, the Department and the FTC worked very hard to adopt a set of Guidelines that are both analytically sound and workable in practice. We believe that the DOJ/FTC guidelines reflect the policy choices necessary to interdict those mergers that threaten competition without unduly impeding transactions that pose no competitive risks. We hope that these comments will assist NAAG in formulating sound enforcement policies. The revision of the NAAG Guidelines provides an opportunity to continue the process of harmonizing federal and state antitrust enforcement efforts.

The August 20th draft reflects an effort in some ways to sharpen analytical principles, improve clarity and to harmonize federal and state approaches. In several places, however, the draft tends to adopt over-simplified standards that exclude consideration of the complex nature of competition in our economy. As a consequence, adoption of the draft in its present form could result in challenges to procompetitive transactions and the failure to challenge transactions that threaten real harm to competition. We believe that the draft could be significantly improved through changes that would:

1. set forth more clearly the analytical steps NAAG will employ in evaluating a proposed merger;

2. adopt an approach to market definition that accounts for the dynamic forces of actual and potential competition;

3. moderate its reliance on market concentration as an indication of possible competitive concerns; and

4. adopt a framework for the evaluation of competitive effects based upon a combination of both structural and nonstructural criteria.

The Department will comment in two distinct ways. In the remainder of this letter, we offer general comments, based in large part on the thematic issues listed above. We also provide a separate appendix setting forth our line-by-line commentary.

Underlying Policies

Section 2 of the August 20th draft sets forth a view of the purposes and goals of merger enforcement based on a perception of the original intent of the drafters of Section 7 of the Clayton Act, as modified by the Cellar-Kefauver amendments. The August 20th draft asserts a strong Congressional intent to arrest industrial concentration and argues for a very specific interpretation of the efficiency goals originally intended when the merger statutes were enacted.

In fact, the legislative history of our merger laws is rich with conflicting opinions as to their purposes and goals. The various floor statements and reports can be read to accommodate widely differing interpretations of legislative intent. The legislative history, however, has no meaning separate and apart from the statute that actually was enacted. Although many who participated in the policy debate presaging the enactment of Section 7 may have spoken of issues such as the risks of concentration, protection of small business and a host of other policy goals, the statute that actually was enacted focuses exclusively on harm to competition. For this reason, we are concerned about Section 2 of the August 20th draft, which attempts to draw from the legislative history a strong Congressional direction to prohibit the formation of concentrated markets, as though prevention of market concentration is itself an appropriate goal under the statute, regardless of any individual transaction's impact on competition.

The Department is equally concerned about the draft's suggestion that the drafters of Section 7 held specific views as to the treatment of merger-related efficiencies, such that one can read the statute as specifically prohibiting wealth transfers and subordinating concerns about productive efficiency to concerns about market concentration. Concepts such as wealth transfer and allocative efficiency have obtained very specific meanings in the modern legal and economic literature surrounding antitrust policy. It is doubtful, however, that the drafters defined, used, or even considered, those concepts in the same ways we do today. Neither the statute nor its legislative history sets forth a clear legislative direction with respect to efficiencies.

Finally, we are troubled by the suggestion in this section of the August 20th draft that the states also may consider consequences of mergers "that are relevant to the social and political goals of Section 7." Section 7 contains a simple direction to prohibit mergers that may tend substantially to lessen competition. No goals, beyond the protection of competition, are suggested or endorsed in the statutory language. The statement that the states may attempt to further other social or political goals -- particularly, the protection of small or regional businesses -- would likely undermine the credibility and legitimacy of state merger enforcement.

We would suggest that the introductory sections of the NAAG guidelines simply state that the purpose of Section 7 analysis is to determine the impact on competition. This is the approach we took in the DOJ/FTC guidelines, and we would encourage NAAG to do likewise.

Market Definition

Market definition is an area that provides NAAG with the opportunity to move its approach into closer alignment with the federal enforcement agencies. The August 20th draft, however, retains the 75 percent rule and continues to insist upon historical evidence of substitution as a basis for including products in the relevant market. Although the draft offers the federal market definition methodology (the 5 percent test) as a possible alternative approach, it does not suggest any specific criteria for deciding which approach might be applicable in a given case. Nor does the August 20th draft specify criteria for rationalizing the two approaches when they produce different results. Thus, the suggestion of two alternative approaches does very little to improve certainty in transactional planning, and may indeed produce greater uncertainty than currently exists. We would urge NAAG to adopt the approach in the DOJ/FTC guidelines or, at the very least, to adopt a test that takes proper account of the dynamic forces of actual and potential competition.

The NAAG market definition methodology, as set forth in Section 3 of the draft, suffers from a number of basic flaws. As an initial matter, the 75 percent test sets up an arbitrary standard that bears no practical relation to the underlying purposes of market definition in merger analysis. The purpose of market definition is to determine the group of products and geographic area over which a firm or firms might exercise market power -- i.e., elevate prices above the competitive level. The 75 percent test, however, does not account for the impact prices of one product might have on prices of, or demand for, other products. Depending on margins, substitution patterns and other factors, an attempted anticompetitive price increase may be defeated by the loss of far fewer than 75 percent of sales.[1] Because the 75 percent test is not grounded in practical economics, it is most likely to produce overly restrictive markets in some cases, and overly broad markets in others.

Second, the August 20th draft exacerbates the problem by precluding any rebuttal of markets presumed under the 75 percent test, except through evidence of past substitution. Merger analysis under Section 7 is by its nature a forward-looking exercise. The requirement that demand substitution be proven solely by historical evidence of prior demand shifts ignores the dynamic forces at work in many markets and significantly understates the impact of potential competition. The mere fact that demand substitution has not occurred in the past is not indicative of the likelihood of future demand substitution under significantly altered market conditions. Exclusive reliance on historical evidence can also lead to allowing anticompetitive mergers.[2] The Department's experience since issuance of the 1982 Merger Guidelines indicates that modern investigative techniques can identify and test probable demand responses to changes in relative prices. Accordingly, there is no basis for the skepticism about such responses that apparently underlies the draft's "empirical evidence" requirement.

Third, the sections addressing potential competition, expansion of output and sources of additional supply are, in our view, overly restrictive. As you know, the DOJ/FTC guidelines take

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[1] The 75 percent test is also problematic because it is only applied to one substitute at a time; it cannot consider a combination of substitutes. Thus if consumers consider two or more alternative products to be close substitutes for the product produced by the merging firms, (e.g., 50% of consumers would shift to substitute A and 50% to substitute B), the draft's market definition methodology would fail to include any of them in the market.

[2] For example, in United States v. Archer-Daniels-Midland Co., 695 F.Supp. 1000 (S.D. Iowa 1987), rev'd, 866 F.2d 242 (8th Cir. 1988) defendants' empirical evidence helped convince the judge that sugar was in the relevant product market. The court of appeals, however, placed this evidence in the proper context and delineated the market on the basis of sound principles applied to other objective facts.

cognizance of the full range of possible demand and supply responses. The DOJ/FTC Guidelines define the market on the basis of actual and potential demand substitution and identify as participants firms presently supplying the market, as well as firms that quickly and profitably likely would make additional supply available through production substitution, product extension and uncommitted entry. The August 20th draft, however, focuses only on firms that have spare capacity.

Certainly, the existence of spare capacity in and around the relevant market can be an important source of competitive discipline. The NAAG Guidelines, however, should acknowledge other potential sources of supply, including those that might involve shifting productive resources or adding new capacity to the market. Firms with divertable capacity that quickly and profitably can be brought to bear on the relevant market -- so-called "hit and run entrants" -- can have the same impact as firms that utilize excess capacity. This, of course, requires an analysis of those firms' capabilities and economic incentives. Our experience has been that such potential supply responses can be identified and evaluated.

The approach taken in the August 20th draft represents a substantial change from the existing NAAG Guidelines and a marked movement away from the DOJ/FTC approach. The existing NAAG Guidelines address production flexibility and quick entry in the section on market definition, while the new draft moves those concepts into the section on entry. Treating these supply responses exclusively as questions of entry is troublesome for two reasons. First, tacking these supply responses onto the end of the entry section has the effect of creating two classes of possible new entry, with no real basis for distinguishing between them, except the fact that one class employs a two year test of timeliness and one employs a one year test. This temporal distinction is not explained anywhere in the draft.[3] Second, eliminating these possible supply responses from the market definition process will have the effect of artificially inflating concentration calculations. This is particularly problematic in the context of the analytical approach proposed in the August 20th draft, which is grounded almost exclusively on concentration and expressly states that nonstructural evidence is both suspect and unlikely to overcome a structural presumption.

The DOJ/FTC guidelines attempt to include as market participants all firms that have a material impact on existing

[3] The DOJ/FTC guidelines distinguish these two types of entry on the basis of sunk costs, treating as market participants those firms that can respond quickly without substantial sunk cost expenditures. A shorter time frame is employed with respect to such firms because we are attempting to assess their immediate impact on pricing behavior in the relevant market.

price levels. This approach is consistent with the underlying purpose of the market definition -- to assess whether a merger is likely to create market power or facilitate its exercise. The 1992 DOJ/FTC guidelines make only minor changes to the market definition methodology that has worked very well and gained widespread acceptance since it was first articulated in the 1982 DOJ guidelines. We would urge NAAG to reconsider whether to continue employing a different market definition test.

Structural Presumptions

Section 4 of the August 20th draft sets forth the general standards for the treatment of market concentration. Standing in isolation, this section is an improvement over the existing NAAG Guidelines. We endorse, for example, NAAG's decision to move away from the unrealistic "likely to challenge" language that both DOJ and NAAG once employed. Nevertheless, several elements of the revised Section 4 raise concerns, particularly when considered in the context of the August 20th draft as a whole.

As an initial matter, we question the decision to impose a presumption with respect to mergers in markets that are only moderately concentrated. The experience gained in applying the DOJ Guidelines since 1982 indicates that mergers in the moderately concentrated range seldom pose competitive problems. Such transactions merit some level of antitrust scrutiny, but there is no basis for presuming that they will be harmful.

Second, Section 4.4, which sets forth special rules for transactions involving what the draft terms leading or new, innovative firms, is problematic. One problem we see with this section is the evidentiary standard it employs. Unlike other sections where the draft guidelines would have the parties "demonstrate" mitigating factors, Section 4.4 requires evidence that "clearly compels the conclusion that the merger is not likely substantially to lessen competition." We know of no credible economic evidence that transactions falling into these concentration ranges are so inherently problematic that they should face such an imposing evidentiary burden. Moreover, there is no reason that the acquisition of a "new, innovative" firm by a firm of arbitrary size, here 20 percent, should be presumed to be anticompetitive, particularly in markets that are only moderately concentrated. The fact that a firm is new or innovative does not necessarily mean that it exercises a special disciplinary force on the market. Indeed, blanket rules barring mergers with such firms could actually be anticompetitive because a merger may permit innovative firms to take advantage of additional capital, marketing or other strengths of the acquiring firm.

Third, we are very concerned about the suggestion in this section that the structural presumptions will strengthen as market concentration increases. As you know, the question of the inclusion of a so-called "sliding scale" was debated vigorously when we consulted NAAG in formulating the DOJ/FTC guidelines. The sliding scale was rejected for several reasons.

There is no inherent reason why certain mitigating factors -- entry in particular -- are likely to be less potent forces in more highly concentrated markets than in less concentrated ones. Moreover, there is no principled basis on which to calibrate the sliding scale. Even those economic studies that purport to find a meaningful correlation between concentration and economic performance generally stop short of making fine distinctions between markets based on relatively small differences in concentration. There is no practical way to implement the sliding scale, except on an impressionistic basis. Focusing again on entry as an example, how does one go about measuring the adequacy of an entry claim relative to the level of market concentration? Does one need to have more documentary evidence of likely entry in a 1350 HHI case than in a 1250 HHI case? Concentration and entry are two distinct aspects of the analysis and, in devising an enforcement policy, should be treated as such.

The sliding scale has the effect of transforming merger analysis into a one-dimensional exercise in which evidence of high concentration always can trump any reasoned analysis of actual competitive conditions. It also gives the government almost unfettered discretion continuously to adjust the burden of proof, without the slightest indication of the basis for the adjustments. We believe that an analysis that relies on the evaluation of the unique conditions actually present in a market will lead to more accurate enforcement decisions than one that relies on generalized, largely theoretical assumptions about the impact of market concentration. Accordingly, we urge the states to abandon the sliding scale in favor of a more rigorous analysis of actual market conditions.

Competitive Effects

The evaluation of nonstructural evidence is the area in which the August 20th draft diverges most fundamentally from federal merger enforcement policy. Since publication of the DOJ Guidelines and the FTC Statement in 1982, both federal agencies have examined a wide range of factors relevant to whether a particular merger is likely to create market power or facilitate its exercise. The 1992 Guidelines merely explain the process through which we analyze such factors by requiring in every case a detailed evaluation of actual market conditions in the context of specific anticompetitive scenarios. With respect to each scenario, the new guidelines explain how various market factors might influence the analysis. In this manner, the new guidelines provide effective guidance to the business community as to both the nature of our competitive concerns and the market factors that influence our enforcement decisions.

The August 20th draft, on the other hand, rejects any consideration of market conditions other than concentration and ease of entry. After expressing the view that current economic techniques have not advanced to a point of relevance to government merger analysis, the August 20th draft states that the only way to overcome the structural presumption is with evidence of ease of entry. Although the draft states that NAAG also will consider collusive behavior and efficiency, neither of those sections offers any way to overcome the structural presumption under the NAAG framework. If anything, they operate to eliminate those considerations. With respect to collusive behavior, the August 20th draft merely asserts that states will not consider ease of entry if they find indications that collusion or oligopolistic behavior presently is occurring in the market.[4] With respect to efficiencies, the NAAG draft says efficiencies will be considered if they prevent prices from increasing. The very next sentence, however, presumes that a price increase will tend to result from a merger in a concentrated market. Thus, the draft appears to presume away the one factual circumstance in which efficiencies will be considered.

Market conditions other than concentration and potential entry can be very important in the evaluation of the likely effects of a particular merger. However, concentration data, interpreted only in light of the potential for new entry, is not predictive of anticompetitive behavior. The experience in applying federal enforcement standards since 1982 indicates that the evaluation of actual market conditions present in the market improves our enforcement effort. Performing this type of analysis generates greater confidence in our prosecutorial decisions and enables us to make more reasoned presentations of our views in the courts. Thus, we would urge NAAG to allow for a broader consideration of market factors other than concentration and entry.

Conclusion

The August 20th draft measures concentration based on historical patterns of supply and demand, and then presumes that mergers in moderately or highly concentrated markets are anticompetitive. The only recognized mitigating factor is ease of entry. The remaining provisions of the NAAG draft guidelines largely serve to bolster the primacy of structural evidence or to exclude other types of evidence that might bear upon the actual competitive impact of the proposed merger. In this sense, the

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[4] The characteristics the August 20th draft describes as being indicative of oligopolistic behavior can also be present in competitive markets. Thus, if the NAAG guidelines are going to use indications of oligopolistic behavior as a basis for precluding entry analysis, they should adopt a more precise manner for identifying such indications.

August 20th draft Guidelines take a static view of relevant markets and would ground enforcement decisions almost exclusively on the theory that concentrated markets are inherently prone to anticompetitive behavior. Such an approach, divorced as it is from actual conditions in particular markets, runs the considerable risk of impeding potentially beneficial mergers, thereby diminishing the competitiveness of firms subject to U.S. merger law. By the same token, this approach would in some instances cause the states to ignore transactions that are likely to harm competition.

The 1992 Horizontal Merger Guidelines reflect the best judgement of the Department and the FTC as to how to interdict anticompetitive mergers without unduly impeding transactions that are unlikely to produce adverse effects. Consistent with that objective, the DOJ/FTC guidelines adopt a wide-ranging and balanced inquiry into the full range of factors that influence competition in a particular market.

In providing these comments on the August 20th draft, we do not mean to suggest that the formulations contained in the DOJ/FTC guidelines are the only correct approaches to the difficult issues involved in merger enforcement. We do believe, however, that there are certain basic elements that are essential to any reasoned approach to these issues, based on the statute, the case law and enforcement experience. Key among those basic elements are: (1) a methodology for market definition that focuses on the potential for market power and recognizes the full range of potential supply and demand responses; and (2) a framework for a balanced assessment of both structural and nonstructural conditions in the relevant market as they affect the likelihood of anticompetitive behavior. The NAAG draft could be materially improved with respect to both elements.

We appreciate the opportunity to comment on the August 20th draft. Needless to say, we would be happy to provide comments on subsequent drafts and would welcome the opportunity to engage in further consultation as your drafting process moves forward.

Sincerely,

Charles A. James

Charles A. James
Acting Assistant Attorney General

cc: Janet D. Steiger (Chairman of the Federal Trade Commission)
Lee Fisher (Attorney General of Ohio)
Richard Blumenthal (Attorney General of Connecticut)
Laurel A. Price (Deputy Attorney General, New Jersey)
Michael L. Denger (ABA Antitrust Law Section Chair)

APPENDIX A

• Page 4, lines 18-21: This definition of market power differs from that in the federal guidelines in important respects. Not included in the NAAG definition are the requirements that the supracompetitive price be profitable for the firm or firms in question, and that the firm or firms be capable of maintaining that price for a significant period of time. Since any firm could raise price unprofitably above the competitive level for a short time, as the definition is written, all unregulated firms could be deemed to possess market power.

• Page 5, lines 14-16: This statement is not correct. A monopolist can be expected to pass on a substantial portion of any decrease in marginal cost.

• Pages 6-7, notes 14-15: The discussion of "consumer welfare" is confusing, resulting from the fact that the term may be used in different ways. Today, economists commonly use it to refer to the welfare of consumers, as opposed to that of producers or that of both consumers and producers. "Total welfare" is more commonly used to refer to the latter.

• Page 9, lines 3-12: It is generally accepted today that the standard for evaluating mergers is essentially the same under Section 1 of the Sherman Act and Section 7 of the Clayton Act. <u>United States v. Rockford Memorial Corp.</u>, 898 F.2d 1278 (7th Cir.), <u>cert. denied</u>, 111 S. Ct. 295 (1990).

• Page 10, lines 6-8: We know of no empirical support for the statement that "most efficiencies and those most quantitatively significant will be realized in mergers involving small firms."

• Pages 10-11, § 2.14: Raising rivals' cost as discussed in this section is simply the exercise of market power with respect to an input, and is more properly considered as a part of the competitive effects analysis.

• Page 12, lines 1-7: Improperly drawn markets, whether too narrow or too broad, can result either in an erroneous challenge of a merger that is not anticompetitive, or failure to challenge a merger that is anticompetitive.

• Page 12, line 8 - Page 13, line 5: This focus on buyers is apparently the result of the adoption by NAAG of a consumer welfare standard and, thus, suffers from the same overall general problems associated with such a standard. More specifically, an "affected-buyers" approach is flawed because the "protected interest group" may often be protected from the exercise of market power by the inability of the sellers to discriminate against them, even if no one in the protected group has any alternative to purchasing from the merging firms. In addition, the Proposed Guidelines provide no specific procedure for identifying the "protected interest group."

• Page 12, lines 11-21: Type I error can also harm consumers if not corrected by courts. Government challenges often are not contested in court, and even when they are contested, courts also can make mistakes. Even if the error is corrected, there will have been expended significant costs of litigation.

• Page 14, lines 11-16: The footnote does not clarify the text. The "x" percentage of alcohol is not given; depending on its value, the provisional market could include one or both products. The DOJ/FTC Guidelines methodology is more precise, beginning with narrowly-defined provisional markets and expanding on the basis of demand substitution factors.

• Page 14, lines 2-4, 17-21: Relevant markets need not consist only of products that are "comparably priced." For some consumers, a high-priced, high quality product may well be a close substitute for a low-priced, low quality product, when all attributes of the products, such as durability and efficiency, are considered. Use of the "comparably-priced" standard can result in a challenge to a neutral or beneficial merger or it can result in the failure to challenge a merger between close substitutes that are not comparably priced. A proper standard would consider the extent to which consumers would substitute to the alternative product in response to a price increase.

• Page 14, lines 30-39: That a price decrease for a product would not induce significant substitution does not necessarily imply that the prevailing price is the result of the exercise of market power or that the product is itself a relevant market. It may be that setting price equal to marginal cost for a particular product results in there being no good substitutes at slightly lower than prevailing prices, but good substitutes at slightly higher prices. If price could not go up as a result of the existence of good substitutes at slightly higher prices, those substitutes should be included in the market.

• Page 15, lines 4-12: This language raises the possibility of price discrimination but fails to explain how consumers subject to price discrimination would be affected by the merger. The DOJ\FTC guidelines (§ 1.12) identify the conditions under which price discrimination is possible and explain how markets are delineated in the presence of price discrimination. We would encourage the proposed NAAG Guidelines to adopt similar standards. Indeed, the proposed NAAG Guidelines do something similar in § 3.21, which considers geographic markets subject to price discrimination.

• Page 15, lines 12-18: This language deals with the possibility that, when products are differentiated, the merging firms' products are particularly close substitutes. That possibility is highly relevant, but such a situation should not be addressed through market delineation. If normal market delineation procedures lead to the conclusion that the relevant market is much larger than just the products of the merging firms, that conclusion should stand.

• Pages 16-17, § 3.2: The NAAG methodology for defining geographic markets is subject to some of the same problems noted above with respect to the NAAG product market methodology. The procedure appears to begin with the assumption that the merging firms are in the same geographic market, no matter how far apart they are (lines 8-11). In fact they may be in separate markets. The "smallest market principle" requires that the analysis begin with the location of each merging firm and expand the area to include locations to which purchasers would turn in sufficient numbers to defeat an attempted exercise of market power by a hypothetical monopolist at that location. Those locations may or may not include both merging parties, and they may or may not include locations beyond which the "protected interest group" purchases 75 percent of their requirements of the relevant product.

• Page 20, lines 11-15: It would be useful to indicate under what circumstances particular measures of market share will be used.

• Pages 20-21, § 3.41: The sentence at lines 17-19 is internally inconsistent. The market shares of domestic firms may be assigned in ways other than "actual current sales" (see ^U 3.4). Further, while foreign firms may be subject to constraints that do not affect domestic firms, it is an overstatement to conclude that foreign firms are "inherently a less reliable check on market power . . . ." It is correct to consider restraints on imports on a case-by-case basis, as this section requires.

• Page 29, lines 3-6, 10-12: Our difficulties with the presumption of illegality attaching to a merger of a "significant competitor" and a "new, innovative firm" are discussed in the text. In addition, we note that mergers of that type may be procompetitive, by enhancing the competitive significance of the innovation. The innovator may lack all of the assets required for successful competition (such as a distribution network or after-sales service) which a successful incumbent can provide. Moreover, a practice of regularly challenging such mergers could have the longer-run anticompetitive effect of discouraging innovation. Entrepreneurs need to be able to "cash out," and the sale to an incumbent may be the only good way to do so.

• Pages 38-42, §§ 5.15A-B: In addition to the issues discussed in the text relating to the treatment of these supply responses, certain technical problems are created by combining these responses with committed entry. It is incorrect to say on page 32, lines 20-22 that the entry treated in this section (§ 5.1) is "new competition that requires expenditure of significant sunk costs." The supply responses in §§ 5.15A-B generally do not involve additional sunk investments. In addition, because significant sunk costs are not incurred, it would be inappropriate to assess the likelihood of such responses on the basis of the premerger price. Finally, the treatment of these supply responses as entry and not as quantifiable competition could, in some instances, have the effect of making it more difficult to challenge mergers successfully. Those unquantified responses, which by definition would be "likely", could assume significance in the eyes of some courts far in excess of their actual probable effect.

- Page 39, lines 13-14: Capacity devoted to internal consumption is relevant not only because some production could be diverted to outside sales, but also because increased sales of products incorporating the relevant product could frustrate an attempted exercise of market power.

- Pages 45-46, § 5.4: We agree that the existence of large buyers is not sufficient to deter or defeat collusion. This section recognizes only one relevant factor relating to powerful buyers, however--that they could themselves enter the relevant market or sponsor entry by others. In addition, a market with large buyers may be characterized by large, infrequent orders, which may make collusion more difficult to sustain.